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Development Lending and the Community Reinvestment Act

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Abstract: These remarks, prepared for the "Issues in Community Economic Development" conference at Western New England College, provide a brief overview of the law and economics literature on urban economic development. I conclude with a set of principles for legislative reform.

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I grew up in a city and believe that their economic health can be taken as a sign or predictor of the health of a nation's economy. Many cities in the United States have fared poorly in recent history, losing businesses and wealthy residents to the suburbs. I noticed a familiar pattern as I read a description of the decline of the Roman Empire in Britain:

> This Roman town life did not last. The damage to the well-to-do classes through high taxation; the ruin of trade through depreciation of the coinage and lack of free, productive industry; the multiplication of officials; civil war, and the plunder of cities by rival armies; these were some – though not all – of the reasons why from the middle of the third century the towns began to lose their amenities. In Britain, for example, the forum of Wroxeter was destroyed by fire about the year 300; it was never rebuilt. At Silchester there is evidence that towards the later period of the life of the town a less civilized class came into possession of the fine houses and did their cooking on the tessellated pavements. At Verulamium the theatre became a stone quarry… The decay of town life did not mean at once the end of Roman culture. The economic basis of the Empire was agricultural, and the Roman villa, like the roman army and bureaucracy, survived long after the Roman town had become a squalid slum.[1]

If we take out the reference to civil war, most of the points in E. L. Woodward's quick list of reasons for decline apply to the experience of many American cities in the 1960s and 1970s. Even the reference to rival armies has some validity: drug prohibition has spawned rival private militias that battle over market territory within cities.

Of course, the news has improved in many cities over the last two decades,[2] but there are also many cases where the turn-around has yet to occur. The full story of the Roman Empire should give us sufficient motivation to find ways to improve the economic health of American cities.

One approach is finance. There is now a growing empirical literature that demonstrates the connection between economic growth and the strength of financial markets.[3] If this connection is true of cities as well, the obvious implication is that the economic turn-around of cities can be enhanced by expanding financial markets to distressed communities within cities. In any event, belief in this proposition led me to study this topic years ago.

Development Lending and the CRA

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[1] E.L. Woodward, History of England 4-5 (Harper & Row Publishers, Inc., 1962)
[2] America's Cities: They Can Yet Be Resurrected, ECONOMIST, Jan. 10, 1998, at 17.
[3] See, e.g., FINANCE AND GROWTH: THEORY AND EVIDENCE, Ross Levine, Working Paper 10766, http://www.nber.org/papers/w10766, NATIONAL BUREAU OF ECONOMIC RESEARCH, 1050 Massachusetts Avenue, Cambridge, MA 02138, September 2004.

In a series of articles on community development lending published in the late 1990s, I criticized the Community Reinvestment Act (CRA).[4] Criticizing the CRA, however, was not the sole focus of these articles. I offered a theoretical framework for analyzing the statute that I hoped would be useful to scholars who attempted either to justify or to condemn the statute. I also offered alternatives to the current approach, pointing especially toward the subsidization of economic development efforts.

Looking back, it appears that I underestimated the degree to which the political controversy surrounding the CRA would color the treatment some later scholars would give to my work. I have been disappointed to find later writers describing me as a "critic" of the statute,[5] along with other "critics" such as Charles Calomiris,[6] Michael Klausner,[7] Jonathan Macey,[8] Geoffrey Miller,[9] George Benston,[10] Peter Swire,[11] and Lawrence White.[12] Not that I mind the company; the list of CRA co-critics makes an extremely impressive team of scholars in law and economics. What troubles me about the critic label is that I, as well as many of the others listed as critics, have tried to set out theoretical and empirical hypotheses that would be equally useful to proponents and critics of the statute. In other words, it was my aim to set out a road map for analyzing community development finance efforts as well as to criticize the shortcomings of the present approach. Moreover, the label "critic" masks the variety of views expressed by scholars who have criticized the statute. Indeed, many of the so-called critics have criticized other critics in addition to criticizing aspects of the CRA. To label them all as one monolithic mass obscures the record of scholarship in this field and fails to respect the sometimes-divergent individual messages offered by each.

[4] Keith N. Hylton & Vincent D. Rougeau, Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act, 85 Geo. L. J. 237 (1996); Keith N. Hylton & Vincent D. Rougeau, The Community Reinvestment Act: Questionable Premises and Perverse Incentives, 18 Ann. Rev. Banking L. 163 (1999); Keith N. Hylton, Banks and Inner Cities: Market and Regulatory Obstacles to Development Lending, 17 Yale J. Reg. 197 (2000).

[5] Dan Immergluck, Credit to the Community: Community Reinvestment and Fair Lending Policy in the United States 278 (2004); Michael Barr, Credit Where it Counts: The Community Reinvestment Act and Its Critics 80 N.Y.U. L. Rev. 513 (2005).

[6] Charles W. Calomiris et al., Housing-Finance Intervention and Private Incentives: Helping Minorities and the Poor, 26 J. Money, Credit, & Banking 634 (1994).

[7] Michael Klausner, Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act, 143 U. Pa. L. Rev. 1561 (1995).

[8] Jonathan R. Macey & Geoffrey P. Miller, The Community Reinvestment Act: An Economic Analysis, 79 Va. L. Rev. 291 (1993).

[9] Id.

[10] George Benston, Discrimination in Mortgage Lending: Why HMDA and CRA Should be Repealed, 19 Journal of Retail Banking Services 47 (1997).

[11] Peter P. Swire, Equality of Opportunity and Investment in Creditworthiness, 143 U. Pa. L. Rev. 1533 (1995).

[12] Lawrence J. White, The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction, 20 Fordham Urb. L.J. 281 (1993).

I will make three arguments below. First, I will briefly review the key points of my earlier papers. Second, I will respond to a few of the assertions made by "the critics of the critics". Lastly, I will discuss the way forward; specifically, principles for urban development and legislative reform.

The Law and Economics of Development Lending: A Brief Review

The three articles I wrote on the CRA, two of them coauthored with Vincent Rougeau, provide different ways of thinking about the problem of financing community development. The first, "Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act," (hereafter *Lending Discrimination*) examines the theory and evidence on lending discrimination and its implications for the CRA. I viewed discrimination, in this article, as the core market failure to consider, and in this sense parted company with the first legal and economic critique of the CRA, that of Macey and Miller.[13]

I disagreed with Macey and Miller on the market failure question. Macey and Miller were clearly aware of the market failure problem, but they argued as if lending markets were efficient, and consequently there was no need for government intervention to correct a shortfall in lending in economically distressed communities. My reason for disagreeing was largely personal. It seemed to me obvious that the unemployment and economic decay observed in several American inner-cities could not be the result of an efficient market.

However, I did not disagree with all of the points made by Macey and Miller – and indeed, I would question my own work if I found that I disagreed with everything they said. Their points about the burdens imposed and investment disincentives created by the statute seemed largely unassailable and in accord with the evidence. Moreover, the policy question they framed remains the question of the moment: are the social benefits provided by the statute greater than the social costs?

In the same paper I discussed empirical issues and provided a preliminary empirical examination of the lending discrimination hypothesis based on lending data provided to the city of Chicago by banks that served as municipal depositories. I stressed the importance of attempting to control for selection effects in any effort to test for discrimination in lending data.[14] For example, if minority mortgage applicants have a preference to live in areas where mortgage default risks are higher, this might lead to higher observed rejection rates even in the absence of discriminatory preferences on the part of lenders.

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[13] Macey & Miller, supra note 8.

[14] Hylton & Rougeau, Lending Discrimination, at 270-77;Yezer, Anthony M.J., Robert E. Phillips and Robert P. Trost, Bias in estimates of discrimination and default in mortgage lending: the effects of simultaneity and self-selection, Journal of Real Estate Finance and Economics 9, 197-215, 1994; Faye Steiner, Quantifying Discrimination in Home Mortgage Lending: Estimation of Loan Price Elasticities Across Products and Races (December 2000). SIEPR Working Paper No. 00-15. Available at SSRN: http://ssrn.com/abstract=262733.

The discrimination hypothesis led me into an exploration of the economic theory of discrimination and its application to the lending market. Following the economic literature, I distinguished *taste-based* and *statistical* discrimination.[15] The former type of discrimination is based on a supposed "taste for discrimination" possessed by the economically advantaged party (e.g., the employer, the lender, etc.). The second type of discrimination, statistical, is based on an effort by the advantaged party to use some superficial characteristic, such as race of the applicant or the racial composition of the applicant's neighborhood, to determine the profitability of an action that affects the applicant (e.g., denial of job, denial of loan).

To my surprise, I found that the statistical discrimination theory had not previously been applied in a detailed manner to the lending discrimination problem, and that the theory was in this respect underdeveloped. A large part of *Lending Discrimination* is an effort to flesh out the implications of the statistical discrimination theory. The theory's implications depend greatly on the accuracy of race (or whatever statistic the economically advantaged party uses) as a predictor and the cost of gathering information.

The second article, "The Community Reinvestment Act: Questionable Premises and Perverse Incentives," (hereafter *Perverse Incentives*) is an exploration of the costs generated by the statute. I did not put serious effort into reexamining the social benefit question, which I had examined in *Lending Discrimination*. I thought it was worthwhile to examine the costs question because previous treatments had focused largely on the paperwork and other direct compliance costs imposed on banks.

The costs of the CRA include, in addition to compliance costs, undesirable incentive effects created by the statute. Some undesirable incentive effects are well known and had been discussed in the previous literature.[16] For example, the fact that the statute's burdens would discourage banks from entering markets in which compliance could be costly had been noted in previous articles. Because of this incentive, lenders that already serve distressed inner-city communities will face less competition, and will therefore be able to charge higher rates to their customers, creating evidence of the underinvestment and price-discrimination that the statute aims to reverse.

Perverse Incentives identifies a few more costs. One is *inadequate incentives*; the failure to offer incentives to a large set of banks and lenders. Of course, this is a cost only to the extent that it represents a welfare loss relative to a regime in which the statute provides optimal incentives. Specifically, banks that did not have expansion plans probably had little incentive to invest effort into compliance. There is empirical evidence that banks that intend to expand try harder to comply with the

[15] Hylton & Rougeau, Lending Discrimination, at 247-252.
[16] Macey & Miller, supra note 8.

statute.[17] The converse would seem to be implied by the same evidence: banks that are not intending to expand have weak incentives to invest in CRA compliance.

Another cost is the incentive to adopt *socially undesirable compliance stratagems*; compliance in a manner that meets regulatory tests but imposes substantial external costs. For example, suppose a bank participates with or finances the work of a predatory lender, in part to satisfy requirements under the statute. Although there is no solid empirical evidence of this, there is some evidence[18] and a disturbingly clear incentive for predatory lenders to enter to take advantage of the incentives created by the statute.

Another category of costs fall under the heading *rent-seeking* costs. Mergers create rents or destroy rents. For example, take the case of a merger that will enhance competition in a local banking market. Such a merger would destroy oligopolistic rents, profits that exist because of the weakness of local competition, earned by incumbent banks. The larger are those oligopolistic rents, the more the incumbent market competitors have an incentive to seek to block the proposed merger. The CRA provides a process by which local competitors can delay or potentially block the merger. Since the oligopolistic rents could be substantial, the local competitors may be willing to invest considerable sums into the regulatory process.

Transaction costs provide another set of costs created by the statute. The statute increases the cost of any merger among regulated entities. The merger is a financial transaction, a contract between two firms. The costs of regulatory compliance become part of the transaction costs of carrying out a merger. Moreover, the transaction costs imposed on the acquiring party create a differential between the merger price agreed between the merging parties and the total price paid by the acquiring firm. Since the amounts invested into the CRA approval process will be forfeited if the merger is not accomplished, the additional transaction costs provide merger targets and third-parties incentives to ramp up their demands during the course of the merger process.

There may be other costs that I have not considered, but my point is straightforward: once we have identified a list of substantial costs created by the statute, the question whether the incremental benefits of the statute exceed its incremental costs becomes somewhat clearer. An empirical effort to determine whether the statute is worthwhile requires, in order to be rigorous, more than an examination of statistics on mortgage lending. A rigorous effort to determine whether the statute is socially desirable as currently enforced would compare the sum of the estimated incremental benefits with the sum of the estimated incremental costs.

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[17] Raphael Bostic, Anna L. Paulson, Hamid Mehran, and Marc Saidenberg (2005) "Regulatory Incentives and Consolidation: The Case of Commercial Bank Mergers and the Community Reinvestment Act", *Advances in Economic Analysis & Policy*: Vol. 5: No. 1, Article 2. http://www.bepress.com/bejeap/advances/vol5/iss1/art2.

[18] Kathleen C. Engel & Patricia A. McCoy, The CRA Implications of Predatory Lending 29 Fordham Urban Law Journal 1571 (2002); see also Hylton, Perverse Incentives, at 185 (discussing Fleetbank case).

The third article, "Banks and Inner Cities: Market and Regulatory Obstacles to Development Lending," (hereafter *Banks and Inner Cities*) reflects an effort to return to the market failure question explored earlier in *Lending Discrimination*. Rather than treating discrimination as the essential market failure, this time I focused on asymmetric information, which struck me as a more plausible account of market failure.

The reasons for focusing on asymmetric information are detailed in the article, but the core one is that the discrimination hypothesis finds little support in the data today and yet the problem of underinvestment remains. The most likely account of market failure is the *asymmetric-information-credit-rationing* hypothesis explored in the economic development literature.[19] I applied that hypothesis to the market for urban development lending. Much of the analysis in *Banks and Inner Cities* is an effort to elaborate the credit rationing theory in the context of urban lending markets.

I concluded that the CRA in conjunction with other banking regulations (especially safety and soundness), should be viewed as an obstacle to development finance. The core reason is a fundamental *mismatch*. The statutory framework is designed in a way that imposes the greatest compliance costs on small, development-oriented banks. Large banks find the compliance costs relatively small and have strong incentives to obtain high compliance grades under the statute in order to facilitate future expansion plans. The mismatch problem is that it is primarily within small, community-development oriented banks where we find individuals who have the most information and the greatest incentives to finance productive community development efforts.[20] Banking sector regulation serves to obstruct the development and expansion of community development-oriented institutions.

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[19] Joseph E. Stiglitz & Andrew Weiss, Credit Rationing in Markets with Imperfect Information, 71 Am. Econ. Rev. 393 (1981).

[20] See, e.g., Brickley, James A., Linck, James S. and Smith, Jr., Clifford W., "Boundaries of the Firm: Evidence from the Banking Industry" (February 2003). Simon School of Business Working Paper No. FR 00-01. Available at SSRN: http://ssrn.com/abstract=204728; Berger, Allen N., Hasan, Iftekhar and Klapper, Leora F., "Further Evidence on the Link between Finance and Growth: An International Analysis of Community Banking and Economic Performance" (July 24, 2003). FEDS Working Paper No. 2003-47; Bank of Finland Discussion Paper No. 8.2004; World Bank Policy Research Working Paper No. 3105. Available at SSRN: http://ssrn.com/abstract=427780; Berger, Allen N., Klapper, Leora F. and Udell, Gregory F., "The Ability of Banks to Lend to Informationally Opaque Small Businesses" (August 2001). World Bank Policy Research Working Paper No. 2656. Available at SSRN: http://ssrn.com/abstract=260575 (results suggest that small relationship-banks have an advantage in lending to opaque small businesses); Craig, Ben R. and Thomson, James B., "Federal Home Loan Bank Lending To Community Banks: Are Targeted Subsidies Necessary?" (August 2001). FRB Cleveland Working Paper No. 0112. Available at SSRN: http://ssrn.com/abstract=282410 (suggests information rather than funding is important constraint); W. Scott Frame, Michael Padhi, and Lynn Woosley, The Effect of Credit Scoring on Small Business Lending in Low- and Moderate-Income Areas, Financial Review, Vol. 39, pp. 35-54, 2004 (credit scoring reduces informational asymmetry and expands lending by large banks to small businesses); Carter, David A., McNulty, James E. and Verbrugge, James A., "Do Small Banks Have an Advantage in Lending? An Examination of Small Business Lending Performance for Large and Small Banks" (January 2002). Available at SSRN: http://ssrn.com/abstract=297007 (evidence that small banks have an advantage in

Banks and Inner Cities suggests that empirical work on the quantity of loans may be inadequate to answer the question whether the CRA's benefits exceed its costs. Whenever one examines a regulatory regime, there is always the question of deadweight loss, which is the difference between the outcome under the statute and what would be observed in the optimal feasible regulatory regime. In an optimally regulated regime, the fundamental mismatch observed under the current system would not be observed. The likely consequence is that development-oriented banks would expand relative to their competitors, and would support a strong entrepreneurial foundation for growth within cities.

A Brief Response to Critics

As I have suggested already, there is now a school of "critics of critics" who appear to assert that the CRA is essentially without flaws.[21] Their work focuses almost entirely on recent empirical studies of lending and does not provide a new or alternative theoretical approach to that offered in the first wave of law and economic analyses that were critical of the statute.[22] Indeed, it appears that the new critics have entirely avoided an effort to grapple with the question posed in the first wave of writing: are the incremental benefits of the CRA greater than its incremental costs?

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small business lending); Clarke, George R. G., Cull, Robert and Martinez Peria, Maria Soledad, "Does Foreign Bank Penetration Reduce Access to Credit in Developing Countries? Evidence from Asking Borrowers" (September 2001). World Bank Policy Research Working Paper No. 2716. Available at SSRN: http://ssrn.com/abstract=285767 (foreign bank penetration increases competition, but benefits go primarily to large firms; suggesting small firms are still best served by local lenders). For a recent discussion of related issues in law-and-development context, see Rashmi Dyal-Chand**,** Reflection in a Distant Mirror**:** Why the West has Misperceived the Grammen Bank's Vision of Microcedit, 41 Stan. J. Int'l L. 1 (2005).

[21] Immergluck; Barr, supra note 5.

[22] Robert E. Litan et al., The Community Reinvestment Act After Financial Modernization: A Final Report, (U.S. Treasury Dept, 2001); Bostic, Raphael W. and Surette, Brian J., "Have the Doors Opened Wider? Trends in Homeownership by Race and Income" (February 28, 2000). FEDS Working Paper No. 00-31. Available at SSRN: http://ssrn.com/abstract=235864 (suggesting regulatory statutes and economic factors have led to an increase in home ownership among lower-income families); Bostic, Raphael, Robert B. Avery and Glenn B. Canner, "CRA Special Lending Programs"; *Federal Reserve Bulletin*, 86: 711-731; 2000 (finding that three-quarters of surveyed institutions cited the CRA as a contributing factor to their mortgage and small-business lending programs); Bostic, Raphael with B. Robinson, "Do CRA Agreements Increase Lending?"; *Real Estate Economics,* 31(1): 23-51; 2003 (CRA agreements influenced lending decisions even after end of agreements); Bostic, Raphael W., Mehran, Hamid , Paulson, Anna L. and Saidenberg, Marc R., "Regulatory Incentives and Consolidation: The Case of Commercial Bank Mergers and the Community Reinvestment Act" (May 21, 2002). FRB of Chicago Working Paper No. WP-2002-06. Available at SSRN: http://ssrn.com/abstract=315027 (banks with expansion plans expanded their lending relative to other institutions). These excellent empirical studies often cited to support the claim that the CRA has improved lending in distressed communities raise three questions. First, to what extent are observed lending increases due to the CRA or other factors? Second, are the incremental benefits of CRA-induced lending greater than the costs? Third, does the statute discourage other approaches that might be more productive? For an empirical article reaching negative conclusions on the effects of the CRA, see, e.g., Jeffery W. Gunther et al., Redlining or Red Herring?, Sw. Econ., Fed. Res. Bank of Dallas, May/June 1999.

Or, one might put the question at a simpler level: what are the incremental benefits of the CRA? What are its incremental costs? The empirical literature has not attempted to answer these questions.

This is not the place to go into a detailed discussion of empirical results. I examined the results in some detail in *Lending Discrimination*, and with a focus on yielding general hypotheses to be tested by future analysts.[23] The new critics have not, from what I can tell, attempted to frame a new or improved set of hypotheses for themselves or for future analysts. They have limited themselves to reporting the results of empirical research that appears to agree with their conclusions (and sometimes disputing the research that disagrees).

The new researchers have not addressed the mismatch issue raised in *Banks and Inner Cities*. There is a fundamental set of questions about the philosophy of development, and about its practice and effect. Should we be satisfied with a regime in which, when working at its best, large banks cross-subsidize lending in distressed communities to an extent that the total amount of lending increases relative to what would be observed in the absence of their cross-subsidization efforts; or should we prefer a regime in which entrepreneurs in distressed communities find ready access to lenders who can help them form productive, job-creating areas of enterprise within these communities?

The existing regulatory regime, though it is coming under pressure to change under the current administration,[24] smacks of a top-down development plan in which large financial institutions make the fundamental decisions on the allocation of credit, responding, with the help of the statute, to pleas and demands for help from various sectors. Within economically distressed communities, the parties that can raise the clearest threat of blocking future expansion plans are the ones most likely to catch the attention of the banks. This plan allows some of the lending that finds its way into distressed communities to be diverted from economically productive endeavors toward politically influential interest groups.[25]

The alternative vision would stress entrepreneurship as the base for community development and attempt to build around that notion.[26] It would minimize the

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[23] Hylton & Rougeau, Lending Discrimination, supra note 4, at 268-279.

[24] Strengthening America's Communities Report, Bush Administration, July 2005 (stressing entrepreneurship model as alternative to existing community development programs sponsored by the federal government).

[25] On the harmful effects of politically-directed credit allocation see, e.g., Levy-Yeyati, Eduardo, Micco, Alejandro and Panizza, Ugo G., "State-Owned Banks: Do They Promote or Depress Financial Development and Economic Growth?" . Available at SSRN: http://ssrn.com/abstract=629384; UNNATURAL SELECTION: PERVERSE INCENTIVES AND THE MISALLOCATION OF CREDIT IN JAPAN, Joe Peek & Eric S. Rosengren, Working Paper 9643, http://www.nber.org/papers/w9643, NATIONAL BUREAU OF ECONOMIC RESEARCH 1050 Massachusetts Avenue Cambridge, MA 02138, April 2003.

[26] Brown, J. David, Earle, John S. and Lup, Dana, "What Makes Small Firms Grow? Finance, Human Capital, Technical Assistance, and the Business Environment in Romania" (October 2004). IZA

discretionary power of government officials and the influence of pressure groups in the allocation of credit.

Going Forward: Principles for Legislative Reform

Based on my earlier work and from what I have seen of the new wave of writing, I think there are some key planks that should form part of a community development finance program, or any legislation for that purpose. They are three: the enhancement of public goods, the subsidization of development efforts, and the reduction of regulatory obstacles.

Public Goods

The most basic public good that a government can provide is security. And yet it is almost entirely lacking in many of the distressed cities. The causes are numerous: the lack of family cohesion, the failure of the education system, and the perverse effects of drug prohibition are some of the most important.

Security is such an important public good that I doubt that it makes sense to talk about community development finance in its absence. Families and businesses will not move into areas in which crime is a high and constant risk. Deserted streets invite criminals to take them over. It is highly unlikely that any bank could, through lending efforts, reverse the small-scale economic depressions created by the lack of security in many cities.

On the other hand, if you take care of security, you will find that businesses and city residents will often be willing to take care of the rest of the development project on their own. Some families are willing to move into areas with weak schools as long as the streets are safe; they can form private schools if necessary. Some businesses are willing to move into areas with undereducated labor forces as long as their businesses are safe; they can train their employees or hire workers from elsewhere if necessary. And when families and businesses are bidding to move into an area of a city, lending institutions will soon follow them.

Admittedly security is expensive, but the alternative, absence of security, is more expensive. The most important community development project that can be undertaken is the provision of security to homes and businesses. It follows that a revenue-strapped municipal government should seek to pare all of its costs except for security. Until security reaches a stage within cities that it is adequate for businesses and families to operate without substantially more risk than experienced in suburban communities, local tax revenues should be devoted primarily to security.

Discussion Paper No. 1343; Upjohn Institute Staff Working Paper No. 03-94. Available at SSRN: http://ssrn.com/abstract=425421 (access to finance matters most in growth of small firms).

Obviously, education is also a priority. However, education can often be funded privately because each recipient of education obtains a valuable benefit. That is why we observe people paying for private schools. Security, on the other hand, is a benefit that is so broadly shared that few people are willing to pay substantial amounts for it (beyond purchasing an alarm system), especially when there is the option of moving to a more safe location. Because the benefits of security are so broadly dispersed and uncapturable by any individual, it is perhaps the most basic of public goods.

Housing values are largely influenced by public goods such as security and education. This is obvious if you simply compare the values of comparable houses in Detroit and in Boston. Detroit is a city that has a high crime rate and a poor education system. Boston has, in comparison, a relatively low crime rate – even in its worst areas crime is still mild in comparison to Detroit – and a decent educational system. If you take a house from Detroit and move it to Boston, you would probably triple its value.

Subsidization

In addition to focusing on security as the foundation of any community development plan, statutory regimes to enhance community development finance should focus on subsidization rather than punishing firms under a one-size-fits-all regulatory structure. This is for several reasons.

First, as I stressed in *Lending Discrimination*, you can achieve the same incentives with a carrot as you can with a stick.[27] Incentives to do any act depend on the payoff for doing the act relative to the payoff for not doing it. You increase the incentive to do an act by widening the spread between these two payoffs. A penalty widens this gap by imposing a cost for not doing the act. A subsidy widens the gap by providing a reward for doing the act.

Sometimes a subsidy is preferable to a penalty. In general, when we want to see the provision of a public good, or a benefit to society, we should subsidize the act. This is the basic distinction found in John Stuart Mill between acts that harm others and acts that provide a benefit to society. Mill argued that punishment should be restricted to the first set of acts. It follows from this view that we if we want to see people pick up trash on the streets, we should subsidize it. The alternative is to punish them for failing to pick up trash, but it should be clear that this would have undesirable incentive effects.

The subsidy has the benefit that it provides a positive incentive and does not tax people for merely falling under the scope of the regulation. When we are considering a productive industry, such as lending, we should be reluctant to pass laws that tax the general activity of lending, unless there is evidence that it is in fact socially harmful. Given this, laws that seek to target lending in a direction not

[27] Hylton & Rougeau, Lending Discrimination, supra note 4, at 282-286.

already induced by the market should attempt to do so through "bribing" rather than punishment.

In general, one can distinguish between substitution and scale effects in regulation. Regulatory penalties induce a substitution toward a desirable act to the extent that they make that desirable act less costly than others. However, regulatory penalties can reduce the level of desirable acts through scale effects, which discourage parties from coming within the scope of the regulation in the first place.

These broad suggestions obviously apply to the CRA. As I suggested in *Perverse Incentives*, the statutory and enforcement should be entirely redirected toward positive rewards. Banks that engage substantially in the community development process should be rewarded with lighter regulatory burdens or tax benefits. This avoids the often-observed conflict between substitution and scale effects in regulation.

Indeed, there is a startling simple and potentially effective subsidization policy that presumably would not require modification of federal law. Individual cities can enhance economic development efforts by using the development-lending records of banks as a basis for determining the amounts held by each as a municipal depository. American cities put enormous sums in accounts held by municipal depositories. If city mayors were to shift those accounts toward small, development-oriented banks, it would provide a powerful spur for banks to expand finance in economically-distressed communities. Alternatively, one could envision a system in which an independent body graded banks according to their economic development efforts within cities and private corporations voluntarily directed accounts to banks on the basis of their success in these efforts.

Reduce Regulatory Obstacles

The third general plank in a sound community development finance program is the reduction of regulatory obstacles. Around the world, there are many existing regulatory obstacles to development lending. Legal systems sometimes inhibit finance by making it difficult to enforce contracts or to use property as security for loans.[28] Some prohibit interest charges above a ceiling rate and, in Islamic countries, even the charging of interest.[29] Some governments control banks and direct their lending.[30] Poor monetary policy leads to inflation, which reduces the scope of financial markets.[31]

Observing some of the stricter forms of regulation in other countries, we may be inclined to view our own system as free of regulatory obstacles. But regulatory obstacles can take many forms. Regulatory laws often benefit one set of firms and

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[28] The Economist, The Hidden Wealth of the Poor: A Survey of Microfinance, Nov. 5, 2005, at 3-4.
[29] Id.
[30] Id.
[31] Id.

disadvantage another set. When this occurs, the firms that benefit gain an incentive to support the law, which may have an anticompetitive consequence. If the losing firms are the ones that are most likely to engage in development lending, then the law, whatever its purpose, can be said to serve as a regulatory impediment to development lending.

We should have an eye out for laws that serve as obstacles to development finance. In many cases, this will mean taking a skeptical view of many banking regulations, because the dominant faction within the larger interest group of banks are the big banks that do not view development lending as core to their mission. The statute-making process will not, as a general rule, favor or protect the business of development-oriented lenders.